

11.02 Operating Leases

Lessor Accounting

- Recognition
 - At the commencement date, the lessor must defer initial direct costs (eg, commissions or payments made to an existing tenant to get them to terminate their lease early). Note: Initial direct costs do NOT include costs that would have been incurred regardless of whether the lease was obtained (eg, advertising, certain legal fees, cost to evaluate a prospective lessee's financial condition, etc.).
 - After the commencement date, both of the following are generally recognized on a straight-line (S/L) basis over the lease term:
 - Fixed **lease payments** are included in income. When there is a difference between the cash received and the amount to be recognized, it is recorded as either Rent Receivable or Deferred Rent, depending on whether the payment received is higher or lower than the lease income to be recognized. Total lease payments / years in lease term = Annual Rent Revenue.
 - **Initial direct costs** are expensed.
 - Variable lease payments are included in income as circumstances occur that fix the lessor's right to such payments (similar treatment for *early termination penalties*).
- **Depreciation** – Lessor depreciates the actual asset (ie, even though the lessee records a right-of-use asset, the leased property itself remains on the lessor's balance sheet as an asset).
- **Rent received in advance** is considered unearned (deferred revenue).
- **Security Deposits**
 - Nonrefundable – unearned revenue until earned
 - Refundable – liability until returned
- **Uneven rental payments** (eg, free rent) are recognized *uniformly* (evenly) over the lease term.

Lessee Accounting

Right-of-use asset and corresponding liability are recorded; no more off-balance sheet financing, except for short-term leases (≤ 1 year).

- **Right-of-Use Asset**
 - Includes:
 - The initial measurement of the lease liability (at PV of lease payments)
 - Any lease payments made at or before the commencement date, less any lease incentives (eg, lease-signing bonus) received
 - Any initial direct costs incurred (eg, commissions, certain legal fees, etc.)
 - *Amortized unevenly* over the term of the lease for the difference between the total lease expense and accreted interest for each period.

- **Lease liability** is recorded at **PV of lease payments**.
 - Variable lease payments are included in the lease liability in the period in which the obligation is incurred.
 - Likewise, early termination penalties are included in the lease liability as a lease payment at PV when it is reasonably certain that early termination will be exercised. This also shortens the lease term used.
 - To determine the PV of the lease payments, the lessee should use the *rate implicit in the lease*, or if it is not readily determinable, the *incremental borrowing rate* can be used.
 - Lessee uses the implicit rate if it is known; this is true even if the implicit rate is higher than the incremental borrowing rate.
 - The incremental borrowing rate is the rate the lessee would otherwise pay to borrow the same amount of money over the same amount of time in a similar economic environment.

Note: The lessor always uses the rate implicit in the lease.

- **Recognition** – After the commencement date, lease payments are expensed over the lease term, generally on a S/L basis. Total lease expense is comprised of accreted interest expense and amortization of the right-of-use asset. While these may be calculated separately, they are reported as a **single straight-line lease expense** each year on the income statement.
- **Leasehold improvements** are reported with PP&E and amortized over the *shorter* of:
 - Remaining lease term
 - Useful life
- **Deposits** – Refundable maintenance deposits, or security deposits, are assets (ie, receivables) if it is probable that they will be returned to the lessee. Maintenance expenses, however, should be expensed in the period incurred or capitalized in accordance with the lessee's maintenance accounting policy.

Example

Assume the client has signed a 5-year rental contract (with no renewal option) for office equipment on 1/1/Y1.

- The economic useful life is estimated to be 10 years.
- The client has an incremental borrowing rate of 6% and the payments are \$10,000 per year, due at the end of each year.
- As an inducement to enter the agreement, the client has been offered the first six months free and a \$1,000 signing bonus.
- The lessee has incurred \$1,000 in initial direct costs.
- The PV factor for a lump sum at 6% for 1 year is 0.943, and the PV factor for an ordinary annuity at 6% for 5 years is 4.212.

- The payment schedule will be as follows:

12/31/Y1	5,000
12/31/Y2	10,000
12/31/Y3	10,000
12/31/Y4	10,000
12/31/Y5	10,000
Total	45,000

In Year 1, the initial entry is:

Right-of-Use Asset*	37,405	
Lease Liability		37,405

*The right-of-use asset is calculated as follows:

Lease liability at PV of lease payments (\$37,405, see calculation below)
 + Lease payments made at or before the commencement date (\$0)
 – Lease incentives (eg, lease-signing bonus) received (–\$1,000)
+ Initial direct costs incurred (eg, commissions) (+\$1,000)
 Right-of-use asset (\$37,405)

The PV of the lease payments is calculated as follows:

- The lump sum of \$5,000 at 6% in Year 1 ($\$5,000 \times 0.943 = \$4,715$).
- The PV of an ordinary annuity of \$10,000 at 6% over 5 years, minus the first-year lump-sum value of \$10,000 at 6% [$(\$10,000 \times 4.212 = \$42,120) - (\$10,000 \times 0.943 = \$9,430)$] = \$32,690.

Total: \$4,715 + \$32,690 = **\$37,405**

Now, since the total of lease payments is \$45,000, lease expense will be recognized on a S/L basis at \$9,000 each year (ie, $\$45,000 / 5$ years). There are essentially two components of lease expense for a lessee in an operating lease: **accreted interest expense** and **amortization expense**. While these may be calculated separately, they are reported as a **single straight-line lease expense** each year on the income statement. Thus, for the first year, the entries will be as follows at 12/31/Y1:

Lease Expense	9,000	
Lease Liability*		2,244
Right-of-Use Asset**		6,756
Lease Liability	5,000	
Cash		5,000

- *Lease Liability is increased for accreted interest: $6\% \times \$37,405$, or \$2,244.

- ****Right-of-Use Asset** is reduced for the amount amortized (ie, the difference between the lease expense and the accreted interest): \$9,000 – \$2,244, or \$6,756.

Again, notice that the total lease expense here is equal to the accreted interest expense of \$2,244, plus amortization expense of \$6,756, for a total of \$9,000 lease expense.

Entries at end of 12/31/Y2:

Lease Expense	9,000	
Lease Liability*		2,079
Right-of-Use Asset**		6,921
Lease Liability	10,000	
Cash		10,000

- *Lease Liability is increased for accreted interest on the 20X2 beginning lease liability amount of \$34,649 (ie, \$37,405 + \$2,244 accreted interest – \$5,000 payment): 6% × \$34,649, or \$2,079.
- ****Right-of-Use Asset** is reduced for the amount amortized: \$9,000 – \$2,079, or \$6,921

Total lease expense will still be \$9,000, consisting of accreted interest expense of \$2,079 and amortization expense of \$6,921.

The following table shows how the lease liability will change over the life of the lease under the effective interest method.

Lease Liability	Interest Rate	=	Accreted Interest Expense	-	Lease Payment	=	Net Reduction in Lease Liability
37,405	6%	=	2,244	-	5,000	=	2,756
<u>(2,756)</u>							
34,649	6%	=	2,079	-	10,000	=	7,921
<u>(7,921)</u>							
26,728	6%	=	1,604	-	10,000	=	8,396
<u>(8,396)</u>							
18,332	6%	=	1,100	-	10,000	=	8,900
<u>(8,900)</u>							
9,432	6%	=	565	-	10,000	=	9,434
<u>(9,434)</u>							
0*							

**Note that there is a \$2 difference due to rounding for simplicity purposes.*

Short-Term Leases

A short-term lease is one that **does not exceed one year** and does not include an option to purchase the asset that the lessee is reasonably certain to exercise. The lessor's accounting is the same as for an operating lease. The lessee, however, has a choice. The lessee may choose to treat such leases the same as operating leases, or, if the lessee so chooses, no asset or liability need be recorded, and lease payments are simply recognized as lease expense.